MICHIGAN SCHOOL BOND LOAN PROGRAM
GUIDELINES FOR BOND STRUCTURES WITH VARIABLE TO FIXED INTEREST RATE SWAP AGREEMENTS

December 16, 2002

School districts may enter into interest rate exchange agreements that provide for a variable interest rate to fixed rate swap. However, bond issues using swap agreements are more complex in nature and may interact differently with the school bond loan fund than bond issues using traditional fixed rate financing structures. By their nature, variable rate structures include certain risks that are not present in fixed rate bond structures and require additional on-going administrative evaluation.

Therefore, school districts entering into variable to fixed rate swap agreements must abide by the following for qualification to participate in the School Bond Loan Program:

Section 1 – Conditions for Approval of Bonds
Section 2 – Conditions for Borrowing from the SBL Fund
Section 3 – Additional Information Required

1. Conditions for Approval of Bonds Using Interest Rate Swap Agreements:

a. Participation in the school bond loan fund does not eliminate the need for a liquidity facility nor is its purpose to mitigate the effects of market, interest rate, counterparty or other risks that might impact the swap agreement.

b. The school district's total outstanding long-term debt should not include more than 25 percent of variable rate debt at the time of issuance unless it has been hedged through a variable to fixed interest rate swap agreement.

c. Bond principal payment dates must be the same as those for fixed rate debt bond issues, May 1 or November 1.

d. The school district may not enter into a swap agreement unless all requirements defined within MCL 141.2317 (Section 317) of the Revised Municipal Finance Act (Act 34) are met.
Re: http://www.michigan.gov/treasury/1,1607,7-121-1751_8013---,00.html

e. Before committing to the swap agreement, the school district must put into place a debt management plan as stipulated in Sec 317(9)(a) of Act 34. The plan should also identify the school district administrators that are responsible for directing the monthly activities of the various agreements.

f. Before committing to the swap agreement, the school district must put in place a swap management plan as stipulated in Sec 317(9)(b) of Act 34. The plan should also address the strategies or events that would result in termination of the swap agreement.

g. The school district must prepare a written acknowledgement of the potential risks, up front & on-going costs and on-going administrative requirements associated with the swap agreement. A copy of this written acknowledgment must be included with the application for final qualification of bonds filed with the Department of Treasury.

h. Bond indenture documents must include the following provisions:
   i. Flexibility to convert variable rate bonds to fixed rate bonds.
   ii. Qualified bonds are not subject to acceleration prior to maturity.
   iii. Notice is given to the Department of Treasury 30 days prior to borrowing from the school bond loan fund as required by MCLA 388.957. (This applies to all payments including early termination payments to swap counterparties.)
   iv. The tax-exempt status of the state debt issued to finance loans to school districts is maintained (required by MCLA 388.959b).
   v. Notice is given to the Department of Treasury of changes in the indenture agreement, swap agreement or counterparties.
   vi. Notice to and approval by the Department of Treasury of change to maximum interest rate, or change to the indenture or swap documents that affect the School Bond Loan Program.
   vii. Advance notice to the extent possible, to the Department of Treasury by the school district if a circumstance occurs that may lead to termination of the swap agreement.
   viii. Termination payments received by the school district may only be used for reasonable direct costs of establishing a subsequent swap agreement. Any excess funds not used for this purpose will be deposited into the debt retirement fund established for the bonds unless specific prior written approval for another use has been received from the Department Treasury.

i. Interest Rate Swap Agreements must include the following provisions:
   i. The notional amount of the swap agreement will never exceed the principal amount of the outstanding bonds.
   ii. As bond payments are made, or in the event of a refunding, redemption or defeasance, the notional amount of the swap agreement will be correspondingly reduced to the principal amount of the outstanding bonds.

j. Indenture and swap documents must conform to the stipulations outlined in the district's application for final qualification of bonds as certified by the school district's board of education.
   Re: http://www.michigan.gov/documents/FQ_Application_12-2002_51351_7.pdf

k. Events of default, termination events, swap transaction provisions (including the selected index), and other provisions outlined in the indenture and swap documents that impact the potential liability of the school bond loan fund, must be acceptable to the Department of Treasury.

2. <u>Conditions for School Districts Borrowing from the School Bond Loan Fund:</u>

Requirements applying to fixed rate and variable rate to fixed rate swap bond issues:

a. During the first year, the full debt levy on all taxing units must be made before borrowing from the school bond loan fund. To avoid borrowing prior to the date when sufficient taxes will be collected, it may be necessary to capitalize interest or establish an initial fixed interest rate period.

b. Loans to a school district from the school bond loan fund may only be applied to principal and interest payments of qualified bonds as defined in Public Act 108 of 1961 (as amended).

c. The debt payment transfer to trustee or paying agent must be made five days prior to the due date.

d. School bond loan proceeds must be expended within five banking days of receipt of the funds.

e. Emergency loan procedures to prevent default of payment of qualified bonds for any reason must remain in full force.

f. If the district has multiple debt funds, the debt millage levy must be properly allocated between funds.

g. Applications for loans must be submitted not less than 30 days prior to the date when the proceeds of the loan will be needed to pay debt service.

Additional requirements for swap based bond issues:

h. A minimum fund balance within IRS regulations maintained to limit borrowing from the SBL fund to the regularly scheduled May and November borrowings.

h. Submission of supplemental schedules detailing the estimated debt service payments projected for the upcoming year during annual preliminary loan application processing to the Department of Treasury.

If changes occur during the terms of the bonds:

i. Written notification if a school district elects to convert the variable rate bonds to fixed rate bonds, or there has been a change to the liquidity facility.

j. Written notification if there is termination of a swap agreement or any change in the counterparties.

k. Written notification if changes are made to the maximum interest rate, to the indenture documents or the swap documents that affect the School Bond Loan Program. Approval of these changes is required. However, approval may be assumed if the Department of Treasury does not respond in writing within ten business days after the school district notifies the Department.

3. Additional Information Required to be Sent to the Department of Treasury for Bond Issues which include Interest Rate Swap Agreements:

With final qualification application:

a. Written acknowledgement from the school district that the school board has been informed of the potential market risks, up front and on-going costs and administrative requirements associated with issuing variable to fixed rate swap.

b. Letter from bond counsel confirming that bond indenture documents and swap agreements include provisions specified herein and that the conditions for issuing variable to fixed rate swap have been met.

c. The school district or its bond working group provide copies of the following documents prior to the determination regarding final qualification:
    i. Analysis that demonstrates the economic benefit of the swap arrangement (after considering on-going costs) when compared to a fixed interest rate structure on a present value basis.
    ii. School district's debt management plan.
    iii. School district's swap management plan.
    iv. Trust indenture agreement and any supplemental agreements or confirmations.
    v. Swap agreement and any supplemental schedules, agreements or confirmations.
    vi. Upon agreement with the Department of Treasury, parties of agreements that have been approved in previous final qualification applications may submit an analysis of differences between current indenture and swap agreement documents and the previous versions in lieu of complete copies of trust indenture or swap agreements.

At the conclusion of each fiscal year, or before additional debt is issued:

d. The school district's chief financial officer should complete an update of the district's debt management plan and a status report of all outstanding swap agreements including an estimate of the termination value.

e. Upon request of the Department of Treasury, the school district should provide a copy of its updated debt management plan and/or its status report including the estimated termination values.

f. The swap agreement and its current status should be appropriately described in the school district's annual audit report.